In those cases where a cable operator elects to forego benchmark regulation for rate of return regulation, the LECs will have achieved effective regulatory parity. Rates and cost allocations will be subject to review, most likely using traditional rate of return concepts similar to those traditionally applied to the common carrier industry. This is precisely why it is important that the benchmark rates are set correctly.

As Dr. Mark Schankerman has pointed out in his statement on behalf of GTE, "if the benchmark procedure is crude, cable operators will be far more likely to apply for relief under cost of service procedures which would destroy both efficiency incentives and administrative simplicity."[27] Therefore, if benchmark regulation is to be successful in providing consumer benefits while at the same time reducing the need to engage in rate of return regulation of the cable industry, then some changes in the approach adopted by the Commission are necessary. Dr. Schankerman advocates the use of additional explanatory variables in the benchmark formulation.[28]

It is not clear why the LECs that sponsored Dr. Emmerson's Affidavit would be concerned even if cable companies were to succeed in raising regulated cable prices. These companies view themselves as potential entrants into cable markets and should therefore welcome the higher prices. On the other hand, it is extremely unlikely that telephone companies would fear below cost pricing from cable companies that provide local exchange substitutes. The cable companies will likely not be regulated in local exchange markets to

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[27] See p. 7.

[28] Id. Also see Lewis J. Perl, Paul S, Brandon, John H. Landon, and Anna P. Della Valle, "A Proposal for Backstop Regulation for Cable Television Prices," filed with the Comments of Time Warner.

the same extent as the LECs. Therefore, they will have no incentive to price at inefficiently low levels. The source of the LECs' concern is more likely that they do not want local exchange competition from the cable companies. Raising the costs of cable companies through forcing them to incur more regulatory burdens will help accomplish that result.

Another factor making it unlikely that cable companies will pursue rate cases in order to charge unreasonably high prices is that LECs are not the only source of competition for cable operators. Cable faces significant competition from, among other sources, free over the air programming. Cable penetration is less than two thirds of television households. The Cable Act of 1992 was itself designed to encourage competition for cable by making programming more widely available to alternative suppliers, such as potential overbuild systems, DBS, MMDS, and new wireless cable technology in the 28 GHz band. Therefore, cable operators are constrained in their ability to extract higher prices from their customers, and this is especially so on a going-forward basis. This will limit the number of attempts to forego benchmark regulation for rate cases, and in the longer run will lead to the elimination of all cable rate regulation, and the distortions it causes.

B. LECs Do Have Incentives to Price Their Services Inefficiently

Concerns over LEC cross-subsidy in cable markets are real.[29] LECs have incentives to misallocate costs in order to underprice their own broadband transmission services. This would harm existing broadband video providers such as cable, wireless cable (MMDS) and

[29] Indeed, the Commission's own rules may themselves lead to cross-subsidy, if not modified. See Daniel Kelley, Cross-Subsidy Concerns Raised by Local Exchange Carrier Provision of Video Dialtone Services, March 29, 1993 (filed with NCTA/CFA Petition for Rulemaking).

Direct Broadcast Satellite. As a result, LECs would capture broadband transmission market share, even if they are not the most efficient providers. This strategy would be costless if monopoly service prices could be increased or, what amounts to the same thing, price reductions for these services could be avoided or reduced. The fact that cable companies and their increasingly sophisticated systems present a potential threat to the LEC monopoly over narrowband transmission provides another incentive for cost misallocation and cross-subsidy.

Unfortunately, it is not possible to remove LEC regulation-induced incentives to behave anticompetitively by simply deregulating the LECs. The LECs have a bottleneck monopoly over an essential service. Removing regulation will subject consumers to substantial risk of monopoly pricing. Removing the Commission's set of competitive safeguards will likely subject competitors of the LECs to cross-subsidy. The Commission and many state regulators have experimented with various ways to modify LEC regulation. Virtually none of these regulators has felt sufficiently confident to eliminate rate of return oversight altogether.

By contrast, rate of return regulation is not being used as the primary means of regulating cable companies. The Commission has found that rates charged by systems that are defined as effectively competitive by the 1992 Cable Act can provide a benchmark against which rates can be compared. No such benchmarks are available for telephone companies since they retain their monopolies.

There may be a legitimate concern that regulation may prevent LECs from responding to competition. However, that is not an issue in this proceeding. Appropriate cost allocation and cost floors should be implemented and a transition path for deregulating telephone companies as competition develops should be designed.

C. "Regulatory Parity" is Not Valuable for Itself

In the Competitive Carrier proceedings, the Commission recognized that non-dominant interexchange carriers do not have the ability to price unreasonably or to discriminate in long distance telecommunications markets. In a series of actions taken over a period of years, the Commission undertook the systematic deregulation of non-dominant carriers. As the success of its procompetitive policies became apparent, reduced regulation was extended to the dominant carrier.

The objective throughout this process was not "regulatory parity." The objective was economic efficiency and competition, which required that regulation be tailored to the unique circumstances of each class of competitors.[30] This process has clearly promoted economic efficiency and competition. Competition in the long distance market is established and consumers have reaped the rewards.[31] Meanwhile, substantial regulatory resources have been saved.

When applied to the current situation, these principles suggest that cable companies should be accorded non-dominant status as they enter new telecommunications markets. As discussed above, they will have little or no incentive to price inefficiently in telephone markets under benchmark regulation. To the extent that rate of return regulation applies,

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[30] The Courts have recently held that the language of the Communications Act does not allow detariffing of common carrier services offered by non-dominant carriers.

[31] See letter to Senator Daniel K. Inouye from Thomas H. Norris, Vice President, Federal Government Affairs, AT&T, August 2, 1993.

they will have to justify cost allocations. There is obviously no concern that they will charge monopoly prices when competing with regulated telephone companies.